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C O N F I D E N T I A L SECTION 01 OF 02 ZAGREB 001829

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TAGS: EFIN ECON HR
SUBJECT: IMF LIKELY TO EXTEND CROATIA STAND BY ARRANGEMENT

Classified By: Economic Officer Nicholas Berliner for Reasons 1.4 b/d.

¶1. (C) Summary and Comment: The IMF expects to extend its current $142.8 million Stand-By Arrangement for Croatia to the end of 2006. However, it considers the GOC's 2006 budget projections anticipating a deficit of 3.5 percent of GDP to be out of line with its commitments, and is also concerned about lackluster performance in key areas of reform, such as reducing industrial subsidies, privatization and reforming entitlement programs. Thus far, the IMF has been very lenient with Croatia when it comes to adherence to its performance criteria, allowing the GOC to put off the politically tough choices necessary to foster greater growth. The Fund believes that it can exert greater influence working with the GOC than it could if it were to force Croatia away from the Stand-By Arrangement. With EU negotiations underway, the IMF hopes that it can bring more leverage to bear on the GOC, as its criteria are very much aligned with those of Brussels. End Summary.

¶2. (U) Econ Officer met with IMF Zagreb representative Athanasios Vamvakidis on November 9 for a readout on the Fund's recent round of meetings with the GOC. Vamvakidis offered a summary of the IMF's engagement with the GOC, centered on its $142.8 million Stand-By Arrangement, its position on Croatia's 2006 budget, as well as readout on a meeting with President Mesic.

GOC 2006 Deficit Projections Too High

¶3. (C) In anticipation of the IMF's second review of Croatia's current Stand-By Arrangement and its possible 6-month extension, Vamvakidis said that the GOC's projections of a 2006 deficit of 3.5 percent of GDP were far too high. The IMF has pushed for a 2006 deficit in a range from 3.0 to 3.2 percent of GDP. Vamvakidis said that such a high deficit for 2006 would be a non-starter for the IMF, although he acknowledged that the Fund has been fairly tolerant with the GOC missing its projections. The IMF acquiesced to the GOC's raising its 2005 deficit in August from 3.7 to 4.2 percent of GDP.

¶4. (C) Econoff asked if the IMF was prepared to take a tougher line with Croatia, even to the point of walking away from the Standy-By Arrangement, if necessary. (Note: Croatia's Stand-By Arrangement is viewed as "precautionary" and has not been used.) Vamvakidis said that the IMF considered that it could be more useful if it remained engaged with the GOC. He noted that the Stand-By Arrangement had strong EU support, since the Fund now carries water for Brussels on many issues, but hoped that this process would be complementary and that the further requirement of meeting EU standards would give the IMF more leverage with the GOC.

Pensioners' Debt Looms

¶5. (U) Getting Croatia's structural deficit under control will be essential as the government faces the prospect of beginning repayment of the "pensioners' debt." The "pensioners' debt" arose from a 1998 ruling by the Constitutional Court holding that the state was responsible for repayment of unpaid pension indexation entitlements from 1993 to 1998. All told, this is a liability now equivalent to between 6 and 7 percent of 2005 GDP, were all pensioners to claim the full amount of their "debt." However, most analysts expect the vast majority of eligible retirees to choose a 2-year, 50 percent repayment plan, which will still amount to a burden of at least 1.5 percent of GDP annually for the government over the next two years. Current plans call for privatization receipts to fund this liability. However, given the slow pace of privatization and the government's reliance year-to-year on these receipts to offset other spending and hold the deficit down, the implications of this outlay cannot be underestimated.

¶6. (U) Vamvakidis said the IMF is also concerned about the amount of liquidity repayment of the pensioners' debt would inject into the Croatian economy and its ability to absorb this amount without setting off inflation and increasing Croatia's already large current account deficit. Early polling of eligible pensioners indicates that few of them would save what they receive, so the IMF is trying to encourage banks to offer savings incentives to draw off some of the money.

Reforms Lagging

¶7. (U) The IMF is also concerned about Croatia's lackluster progress in carrying out structural reforms. Vamvakidis noted that Croatia's level of industrial subsidies amounts to 3.8 percent of GDP annually, with the railroads and agriculture alone soaking up two-thirds of this amount and other industries such as shipyards and metals plants getting the rest. He said that the IMF would push hard on this with the GOC, as well as in the reform of entitlement programs and the further reform of the healthcare system. Many entitlement programs are rife with fraud, as no effective means tests exist to determine eligibility. In healthcare, Croatia recently introduced a co-payment system, but with so many exemptions that it will likely have little effect in reducing chronic over-consumption of health services. Despite citizens' constant complaints about the poor quality of healthcare, Croatia spends over the EU average at about 7.3 percent of GDP.

PM Sanader Go-To Person on Economy

¶8. (C) Vamvakidis commented on the formulation and execution of economic policy in Croatia, noting that progress came only when PM Sanader engaged personally. He said that the IMF now tailors all visits to Croatia to Sanader's schedule, as he appears to be the only one able to deliver action in the government. He described Finance Minsiter Suker as a marginal player, unable to bring other ministries along on key fiscal and monetary issues. He assessed that Deputy PM Polancec has the PM's ear and hoped that he would be able to deliver on the privatization and restructuring mandate entrusted to him.

¶9. (C) The IMF also met with Croatian President Mesic, an unusual move, given that the president has no formal role in the formulation or execution of economic policy. Constitutional limitations, however, have not stopped Mesic from expounding on economic issues, sometimes in ways more suggestive of his socialist past (Mesic was the last president of Yugoslavia) than current reality, such as

comments about the importance of rebuilding heavy industry or suggestions that foreigners be restricted in their ability to buy property in Croatia. Vamvakidis said that the IMF had hoped to bring Mesic around on some of these issues, but left the meeting generally doubtful that Mesic will refrain from statements that, while politically popular, often give succor to opponents of economic reform.
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